Press release

LCQ17: The competitiveness of the Hong Kong stock exchange

Wednesday, April 6, 2011

Following is a question by the Hon Abraham Shek Lai-him and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (April 6):

Question:

It has been reported that although the market capitalisation of the securities traded in the stock exchange of Hong Kong is the world's seventh-largest, and the financial services industry in Hong Kong accounts for about 16% of the gross domestic products, the securities turnover of Hong Kong in recent years has never reached the top 10 because of the high trading costs. It has also been reported that the securities trading costs in Hong Kong are 35% and 25% higher than those in the United States (US) and the United Kingdom respectively, which discourages institutional investors from trading frequently and thus impacts on the overall trading volume. In this connection, will the Government inform this Council:

(a) whether it has considered implementing any measure to lower the securities transaction costs so that the competitiveness of Hong Kong's stock exchange may be maintained; if so, of the details regarding its timetable for public consultation;

(b) given that dark pools which help keep trading costs down have already been established in the US, Europe and Japan, whether the Government will consider encouraging the development of dark pools in Hong Kong to boost trading; if so, of the details; if not, the reasons for that; and

(c) as it was reported that the Hong Kong Exchanges and Clearing Limited would spend $1 billion to build a lightning-fast data and processing centre over the next three years to increase the liquidity in the market, whether it knows if any measure will be taken to lessen market volatility which may be caused by such high-speed automated trading, so that incidents similar to the "Flash Crash" in the US last year, which had resulted in the Dow Jones Industrial Average plunging 700 points in a matter of minutes, will not occur in Hong Kong?

Reply:

President,

My reply to the three parts of the question is as follows:

(a) As at end 2010, Hong Kong ranked 10th among exchanges in the world in terms of turnover. We note the press report about higher trading costs in Hong Kong on January 10, 2011. According to the report, the relevant cost analysis covers the cost of spreads, brokerage charges and other implicit costs of implementing the trade arising from the difference between the price that the investor intended and what was actually executed. The latter relates to spreads and, according to some brokers, the lack of anonymity whereby some orders can be paired with the broker's identity. In the past, the Hong Kong Exchanges and Clearing Limited (HKEx) has reduced spreads and considered anonymity, but these have turned out to be controversial with some market participants. HKEx believes that such changes would be beneficial to the market. It will continue to explore with the market on the best way forward.

(b) Currently, there are 13 dark pools operating in Hong Kong. They are mainly brokers/banks' internal crossing engine whereby their customers' orders would be channelled to the internal pool for matching. Currently, trades conducted in these dark pools are required to be reported to HKEx, and HKEx provides post-trade transparency through its market data system.

We note that the emergence of dark pools has raised concerns over the lack of transparency which could create a two-tiered market that deprives the public of information about trades and liquidity in dark pools. We understand that the United States (US) and the European Union are also reviewing their regulatory framework for dark pools in relation to, among other things, transparency.

The Securities and Futures Commission (SFC) has been actively participating in international discussions on regulatory issues related to dark liquidity. Together with the SFC, we will continue monitoring the development of dark pools in Hong Kong and other major markets.

(c) The US "flash crash" on May 6, 2010 is attributed to the ill-timed execution of an automated execution algorithm that was programmed to feed orders into the E-Mini market without regard to price or time. The plunge in prices was caused by many factors. They include very fragmented execution venues with different rules and practices; the retreat of liquidity providers and high frequency traders from the market; and the presence of "stub quotes" (i.e. quotes placed by liquidity providers at extreme prices to fulfill liquidity obligations or by bottom fishers looking for bargains) coupled with widespread use of market and stop loss orders. These factors are absent in Hong Kong. For example, HKEx has imposed a set of order entry rules that restrict orders being placed far away from the current market, serving as a safeguard in our market to prevent the occurrence of a "flash crash" similar to the one occurred in the US.

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